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BankThink Three reforms CDFIs need to help build stronger communities

By Eugene Ludwig, Don Riegle July 30, 2021, 10:05 a.m. EDT 4 Min Read

No one can reasonably deny that when the overall economy gets a cold, low- and moderate-income individuals and neighborhoods get the flu, largely through no imprudence of their own. History proves that lower-income families, particularly those comprising people of color, get fired first and rehired last. As a result, no matter how hard they work to save, they're almost always left a step behind. The Great Recession was a clear example: While a range of big banking institutions were given taxpayer bailouts, more modest communities were left with a Sisyphean boulder. As we emerge from the pandemic, the cycle is apt to repeat itself.

One tool we should use to address this perennial problem has emerged from the world of finance. Despite decades of often fruitful work inducing ordinary banks to serve lower-income communities, many poorer neighborhoods today remain inundated with check-cashing storefronts and pawnbrokers. Many lower-income borrowers have little choice but to deal with loan sharks who make it unreasonably expensive to build real credit and to climb the economic ladder.

Fortunately, beyond encouraging banks to serve these lower-income communities, a third alternative has emerged. Appearing to consumers much like an ordinary bank, but operating against a different set of incentives, community development financial institutions, or CDFIs, such as Industrial Bank in Washington, D.C., and Southern Bancorp in Arkansas, are proving to be an indispensable tool in the fight against endemic

As a primary step, we need to change the regulatory framework. Because CDFIs are mission driven — or, to put it more plainly, because they are less slavishly committed to maximizing profits — they are willing to make riskier loans than a traditional bank would be inclined to extend. But because they are governed by the same rules that apply to ordinary banks, in most cases, their ability to make loans is pared back in good times for fear that borrowers will renege when the economy turns sour.

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We should free CDFIs from some of the regulatory burdens that are only appropriate for much larger, high-profit-seeking lending institutions. Congress should take a close look at mark-to-market accounting policies that unfairly price assets at one particular point in time — for instance when a house is priced at rock bottom during a downturn. If CDFIs were permitted to use valuations over time, they would be able to extend additional credit where it's needed most, precluding the foreclosures that often decimate low- and moderate-income community banks. Most often, as the cycle returns to normal, property values rise and jobs return.

Second, we should provide CDFIs significantly more financial cushion, ensuring they have the reserves required to make additional loans in the places that are barraged during each successive downturn. A quarter-century ago, Sen. Riegle worked as chairman of the Senate Banking Committee to direct federal resources to CDFIs through a special fund. Sen. Mark Warner, D-Va., and others, including Vice President Kamala Harris, managed to include additional resources in the COVID-relief package. But much more can be done to augment the capital CDFIs have on hand to loan out. Which points to our third proposed reform.

To date, private-sector support for the CDFI movement has principally come from banks. Today, we need to induce nonbank entities, which have more recently benefited from the Federal Reserve's safety net, to do their part to lift up CDFIs, both by way of buying equity in existing entities and starting new ones. This includes hedge funds, private equity firms, insurance companies, and investment management companies.

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manner. At the same time, banks that invest should get triple the credit they currently receive under the terms of the Community Reinvestment Act.

Support for CDFIs is essential — every targeted community should have not just one but two competing to serve the neighborhood. But we should be clear these are just part of the picture for low- and moderate-income America. The bedrock of what is needed is good, high-paying, private-sector jobs. And in many cases that means access to free or low-cost education and career-building opportunities. In parallel, America has to do a better job of creating a climate for private-sector business growth that results in high-wage jobs that can support a family.

It is only with this type of climate that CDFIs and other financial institutions, as well as tools such as the CRA, can do their part to bridge income and wealth gaps in a safe and sustainable way.

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